

# Tulsa Law Review

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Volume 20 | Issue 3

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Spring 1985

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### Recommended Citation

Emily J. Crawford, *The Market Value Gas Royalty Clause Controversy Continued: Piney Woods Country Life School v. Shell Oil Co.*, 20 Tulsa L. J. 473 (2013).

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# THE MARKET VALUE GAS ROYALTY CLAUSE CONTROVERSY CONTINUED: *PINEY WOODS COUNTRY LIFE SCHOOL v. SHELL OIL CO.*

## I. INTRODUCTION

During the past few years, the courts in several jurisdictions have been called upon to interpret royalty clauses in gas leases.<sup>1</sup> The purpose of these clauses in oil and gas leases is "to describe the benefits which are intended to inure to the lessor as the result of the extraction of . . . valuable substances by the lessee."<sup>2</sup> These clauses determine the size of the royalty a lessor, or mineral owner, will receive as payment from the lessee, or producer, for the privilege of producing oil and gas.<sup>3</sup> Furthermore, payment of the royalty provided for in the lease may consist of the delivery of a share of oil or gas in kind<sup>4</sup> or the payment of money.<sup>5</sup> A gas lease royalty clause providing for the payment of money may be in one of two basic forms. In the first form, the royalty is stated as a fixed amount.<sup>6</sup> In the second, the royalty is calculated as a percentage of the value of the gas or of the amount realized from the sale of gas.<sup>7</sup>

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1. See, e.g., *Hillard v. Stephens*, 276 Ark. 545, 637 S.W.2d 581 (1982); *Lightcap v. Mobil Oil Corp.*, 221 Kan. 448, 562 P.2d 1, *cert. denied*, 434 U.S. 876 (1977), *reh'g denied*, 440 U.S. 931 (1979); *Henry v. Ballard & Cordell Corp.*, 418 So. 2d 1334 (La. 1982); *Tara Petroleum Corp. v. Hughey*, 630 P.2d 1269 (Okla. 1981); *Exxon Corp. v. Middleton*, 613 S.W.2d 240 (Tex. 1981).

2. 3 E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 38.1, at 239 (1967).

3. *Id.* § 38.2, at 240. One author states that "economically the most important clause to the lessor is the royalty clause; the lessor's hope at the time of the execution of the lease is for production and the payment of royalty." 3 H. WILLIAMS, OIL AND GAS LAW § 641, at 499 (1980).

4. 3 E. KUNTZ, *supra* note 2, § 38.2, at 241. The right of the lessor to this type of royalty is the right to delivery of the royalty oil or gas, i.e., the right to ownership of personal property. Provisions for delivery of royalty gas in kind are not common, however. See *id.* § 40.3, at 297.

5. *Id.* § 38.2, at 240. The lessor's right with respect to this payment is a contractual right. The lessor retains no property rights to the oil and gas. *Id.* at 241-42.

6. *Id.* § 40.2, at 292. Fixed royalty provisions were used in the early days when gas had little or no value. These provisions were generally included in the lease only when the well produced only gas. Such a provision was drafted as a covenant by the lessee to pay the lessor the fixed sum of money or be liable for breach. *Id.* at 292-93. See, e.g., *Union Producing Co. v. Browne*, 165 So. 2d 506 (La. Ct. App. 1964); *Central States Prod. Corp. v. Jordan*, 184 Okla. 262, 86 P.2d 790 (1939); *Gladys Belle Oil Co. v. Turner*, 12 S.W.2d 847 (Tex. Civ. App. 1929).

7. See 3 E. KUNTZ, *supra* note 2, § 38.2, at 241-42. The amount realized from the sale of gas would be the gas sales contract price. For examples of royalty clauses, see 1 E. BROWN, THE LAW OF OIL AND GAS LEASES § 6.12 (rev. 2d ed. 1984); 3 H. WILLIAMS, *supra* note 3, § 641. One common royalty clause uses both "market value" and "amount realized":

[O]n gas . . . produced from said land and sold or used off the premises . . . [the royalty

The problems which developed with the royalty clauses in gas leases are due to the nature of the gas and the evolution of the clauses.<sup>8</sup> In the early days of the industry, gas had little or no value.<sup>9</sup> As gas became more valuable, its volatile nature made marketing difficult.<sup>10</sup> Natural gas could not be stored economically in tanks, as could oil.<sup>11</sup> Instead, the gas wells were hooked into pipelines.<sup>12</sup> The expense of these pipelines, coupled with other production costs, caused the purchasers to require long-term gas contracts.<sup>13</sup> The sellers were forced to accept these contracts because they were obligated to the lessors to market the gas.<sup>14</sup> Thus, many long-term gas sales contracts without price escalation clauses provided that sale prices were to remain constant for twenty years or more.<sup>15</sup> When interstate sales of natural gas were regulated in 1954, maximum prices were set and any existing escalation clauses were suspended.<sup>16</sup> However, because gas in intrastate commerce was unregulated, its price rose dramatically.<sup>17</sup>

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shall be] the market value at the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells, the royalty shall be one-eighth of the amount realized from such sale.

Exxon Corp. v. Middleton, 613 S.W.2d 240, 242 (Tex. 1981) (emphasis added).

8. See generally 3 E. KUNTZ, *supra* note 2, § 40.1; Fischl, *Ascertaining the Value or Price of Gas for Purposes of the Royalty Clause*, 21 OKLA. L. REV. 22 (1968); Hollimon, *Exxon Corporation v. Middleton: Some Answers But Additional Confusion in the Volatile Area of Market Value Gas Royalty Litigation*, 13 ST. MARY'S L.J. 1 (1981); Lowe, *Developments in Nonregulatory Oil and Gas Law*, 32 INST. ON OIL & GAS L. & TAX'N 117 (1981).

9. Fischl, *supra* note 8, at 23. Thus, no lease provisions were made for gas royalty payments. *Id.*

10. See 3 E. KUNTZ, *supra* note 2, § 40.1, at 290; Hollimon, *supra* note 8, at 6.

11. Lowe, *supra* note 8, at 145.

12. *Id.*

13. *Id.*; see also Hollimon, *supra* note 8, at 6 (discussion of the expenses and the necessity for long-term contracts between producers and purchasers).

14. 1 E. BROWN, *supra* note 7, § 6.09, at 6-65; see also M. MERRILL, *THE LAW RELATING TO COVENANTS IMPLIED IN OIL AND GAS LEASES* § 84 (2d ed. 1940); 5 H. WILLIAMS & C. MEYERS, *OIL AND GAS LAW* § 853 (rev. ed. 1984) (discussion of implied duty to market). The implied covenant to market gas is generally stated as the "duty to use due diligence to market the product." 5 H. WILLIAMS & C. MEYERS, *supra*, § 853, at 389. Furthermore, Williams and Meyers state that "[s]ince return to the lessor [in the form of the royalty] is dependent upon the sale of the product once it is discovered, the implied covenant to market can be viewed as another application of the duty of cooperation that governs the relation of the parties to the lease contract." *Id.* at 390. The duty to market arises under any lease in which royalty is payable in kind or is based on a fraction of the gas produced. *Id.* This duty would then require the lessee to enter into the best available sales contract at the time. M. MERRILL, *supra*, § 84, at 213. Remedies for breach of the duty are damages, or if inadequate, forfeiture of the lease. 5 H. WILLIAMS & C. MEYERS, *supra*, § 854, at 398.

15. Lowe, *supra* note 8, at 145.

16. Natural Gas Act, 15 U.S.C. §§ 717-717w (1982).

17. Lowe, *supra* note 8, at 146. Different categories of intrastate gas are now regulated by the Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301-3432 (1982). See generally Green, *The Natural Gas Policy Act: Its Problems and Prospects*, 10 OHIO N.U.L. REV. 425 (1983); Morgan & Patterson, *The Natural Gas Policy Act of 1978: Four Years of Practice and Two Years to Make Perfect*, 71 KY.

Royalty owners, observing that new sales contracts provided for higher prices than the long-term gas sales contracts from which their royalties were calculated, began searching for ways to obtain royalties based on these higher rates.<sup>18</sup> The royalty owners began initiating suits to recover what they felt were underpayments of royalty.<sup>19</sup> They argued that the term "market value" in the royalty clause should be interpreted as the *current* market value.<sup>20</sup> The lessees, in turn, contended that it was the practice of the industry to equate market value with the amount realized on the sale.<sup>21</sup>

The courts in the early cases decided in favor of the lessors by holding that market value or market price means current market value.<sup>22</sup> However, later cases did not look to the literal meaning of the words but, instead, looked to the intention of the parties and to the industry practices.<sup>23</sup> These cases held that market value is the gas sales contract price, or the amount realized from the sale of the gas.

The latest case dealing with the gas lease royalty clause controversy is *Piney Woods Country Life School v. Shell Oil Co.*<sup>24</sup> In a well-reasoned opinion affirming in part and reversing in part the district court's decision in favor of the lessees,<sup>25</sup> the Court of Appeals for the Fifth Circuit decided that market value means the current market value when the gas is produced and delivered.<sup>26</sup> The court based its decision on the "plain meaning of the words" in the lease. Nevertheless, the court did interpret other controversial language in favor of the lessees by looking to the parties' intentions and the customs of the industry.<sup>27</sup> However, the failure of the court to apply the intention of the parties approach throughout its

L.J. 105 (1982); Silva and Rainey, *Learning to Live With the NGPA-The Cents and Nonsense*, 26 ROCKY MTN. MIN. L. INST. 703 (1980).

18. Lowe, *supra* note 8, at 146.

19. Hollimon, *supra* note 8, at 7.

20. *Id.*

21. Lowe, *supra* note 8, at 146. Lowe states that "[m]any of the oil and gas lease royalty clauses that were developed from the 1920s through the 1960s used references to market value or market price at the well interchangeably with references to the amount realized at the well." *Id.* (citation omitted). Furthermore, according to Lowe, if market value is computed "at the well," but gas is sold off the premises, market value might be less than amount realized. This is because the amount realized may include transportation or processing costs. *Id.* at 147; *see infra* notes 50-51 and accompanying text.

22. *See, e.g., J.M. Huber Corp. v. Denman*, 367 F.2d 104 (5th Cir. 1966); *Foster v. Atlantic Ref. Co.*, 329 F.2d 485 (5th Cir. 1964); *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968).

23. *Hillard v. Stephens*, 276 Ark. 545, 637 S.W.2d 581 (1982); *Henry v. Ballard & Cordell Corp.*, 418 So. 2d 1334 (La. 1982); *Tara Petroleum Corp. v. Hughey*, 630 P.2d 1269 (Okla. 1981).

24. 726 F.2d 225 (5th Cir. 1984).

25. 539 F. Supp. 957 (S.D. Miss. 1982), *rev'd in part, aff'd in part*, 726 F.2d 225 (5th Cir. 1984).

26. *Piney Woods Country Life School v. Shell Oil Co.*, 726 F.2d 225 (5th Cir. 1984).

27. *Id.* at 231.

decision perpetuates a view that is contrary to that of the industry, and necessitates the use of preventive devices by the industry.<sup>28</sup>

## II. STATEMENT OF THE CASE

This class action resulted from the rising natural gas prices caused by OPEC in the early 1970's.<sup>29</sup> The lessors and Shell entered into the Mississippi oil and gas leases in the mid-1960's.<sup>30</sup> Shell used three different royalty clauses in seven different forms.<sup>31</sup> The relevant portions of the leases generally stated that the royalty for gas sold or used off the premises was based on the market value at the well, while the royalty for gas sold at the well was based on a percentage of the amount realized from the sale.<sup>32</sup> Because the gas from these wells was sour, Shell processed or treated the gas before selling it.<sup>33</sup> The gas was sold on the intrastate market to two buyers,<sup>34</sup> and both contracts provided for price escalations.<sup>35</sup> These contracts also provided that title to the gas passed in the field before the gas was processed.<sup>36</sup> However, the buyers' actual

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28. See *infra* text accompanying notes 182-90.

29. *Piney Woods*, 726 F.2d at 228. Shell had committed the gas for sale at pre-OPEC prices under long-term contracts. *Id.*

30. *Id.*

31. *Id.* The three royalty provisions were termed by the district court as the "Commercial," the "Producers 88-D9803," and the "Producers 88 (9/70)." *Id.* The "Commercial" provision provided for royalty

on gas, including casinghead gas or other gaseous substance(s), produced from said land and sold or used, the market value at the well of one-eighth ( $\frac{1}{8}$ ) of the gas so sold or used, provided that on gas sold at the well the royalty shall be one-eighth ( $\frac{1}{8}$ ) of the amount realized from such sale(s) . . . .

The "Producers 88-D9803" provision provided for royalty

on gas, including casinghead gas or other gaseous substance, produced from said land and sold or used off the premises or in the manufacture of gasoline or other product therefrom, the market value at the well of one-eighth of the gas sold or used, provided that on gas sold at the wells royalty shall be one-eighth of the amount realized from such sale . . . .

The "Producers 88 (9/70)" ordered the lessee

to pay lessor on gas and casinghead gas produced from said land (1) sold by lessee, one-eighth of the amount realized by lessee, computed at the mouth of the well or (2) when used by lessee off said land or in the manufacture of gasoline or other products, the market value at the mouth of the well, of one-eighth of such gas and casinghead gas . . . .

*Id.*

32. *Id.*

33. *Id.* at 229. Shell treated the sour gas at its plant, and recovered "sweet gas" (dry methane) and elemental sulphur. *Id.*

34. *Id.* These buyers were MisCoa, a partnership of two Mississippi corporations, and Mississippi Power and Light (MP & L). *Id.*

35. *Id.* The contract between Shell and MisCoa provided for a sale price of 53¢ per mcf (thousand cubic feet) with an increase to 54.59¢ after 15 million mcf were delivered and then with a price escalation of three percent per year. Shell's contract with MP & L to sell excess gas was for 45¢ per mcf, with escalation of one percent per year. *Id.*

36. *Id.*

control of the gas did not occur until it was processed.<sup>37</sup> Shell paid royalties based on actual revenues from sales of sweet gas and sulfur, and not based on the market value.<sup>38</sup> Then, a substantial part of the processing costs were deducted from the royalties.<sup>39</sup>

The lessors brought suit in 1974<sup>40</sup> alleging that the royalty payments were improperly calculated.<sup>41</sup> In 1982, the district court found that Shell did not err in deducting the processing costs from the royalty payments or in basing the royalties for gas sold on the actual amount realized because title passed at the wells.<sup>42</sup> However, the court found that gas consumed in off-lease operations should have incurred royalties computed by current market value.<sup>43</sup>

The case was certified for appeal.<sup>44</sup> On appeal, the court stated that the issues to be considered were "the meaning of 'market value' and 'sold at the wells' in a royalty clause and the propriety of deducting processing costs from the lessors' royalties."<sup>45</sup> The court also considered where the point of sale occurred for the contracts.<sup>46</sup>

### III. LAW PRIOR TO THE CASE

#### A. General Background of the Market Value Controversy

As mentioned earlier, a study of the background of the market value

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37. *Id.* The MisCoa contract used measurements of quality and quantity to determine the price. These measurements were not made until the gas was "redelivered" as sweet gas off the field. The MP & L contract provided for "redelivery" near Shell's plant. Furthermore, it appears that the parties agreed that title would pass at the wells in order to avoid state regulations on pipelines. *Id.*

38. *Id.*

39. *Id.* Generally, royalty is to be paid to the lessor free from the costs of production, but lessees are allowed to deduct expenses subsequent to production when the royalty is payable "at the well." That is, the royalty is "subject to a proportionate share of the costs incurred subsequent to production." 3 H. WILLIAMS, *supra* note 3, § 645, at 594. The courts have allowed deductions for production and severance taxes, transportation expenses, and treatment, compression, and manufacturing expenses required to make the product salable or more valuable. *Id.* at § 645.2. But see M. MERRILL, *supra* note 14, § 85, where he states that

[i]f it is the lessee's obligation to market the product, it seems necessarily to follow that his is the task also to prepare it for market, if it is unmerchantable in its natural form.

. . . [I]t is erroneous to read into the royalty clauses stipulations concerning the costs of marketing and preparation which are not specifically expressed.

*Id.* § 85, at 214-16.

40. *Piney Woods Country Life School v. Shell Oil Co.*, 539 F. Supp. 957 (S.D. Miss. 1982).

41. *Id.* at 960.

42. *Id.* at 973, 977.

43. *Id.* at 977. The court, however, rejected the evidence presented by the lessors on computing market value and requested further evidence. *Id.* at 986. The court also rejected, without explanation, the lessors' claims for royalties on the gas consumed by Shell at its plant. *Id.*

44. *Piney Woods*, 726 F.2d at 230.

45. *Id.*

46. *Id.* at 231-33.

controversy begins with a look at the nature of gas and the development of the gas royalty clause.<sup>47</sup> As long as the current market value equalled the gas sales contract prices, there were no disputes caused by the language in the royalty clause. However, once interstate gas became regulated and intrastate prices rapidly increased,<sup>48</sup> lessors felt that their royalties were being underpaid.<sup>49</sup>

Early clauses used "market value" or "market price" interchangeably with "amount realized" when the gas was sold at the well.<sup>50</sup> The draftsmen of the early leases apparently intended "market value at the well" to equal the contract price when the gas was sold at the well and to be less than the contract price when sold or consumed off the well. If the gas was sold off the well, transportation and processing costs could then be deducted in order to arrive at a value similar to that of gas sold at the well.<sup>51</sup> Thus, "at the well" refers not only to the location of the gas when sold but also to the state of the gas.

The courts have followed two views in interpreting market value or market price in gas royalty provisions.<sup>52</sup> The first view is that market value is actually the current market value.<sup>53</sup> This view looks to the plain meaning of the words in the lease.<sup>54</sup> In contrast, the second view holds that "market value at the well" is the gas sales contract price if the contract was entered into at arm's length and in good faith.<sup>55</sup> This view considers the intention of the parties and the realities of the oil and gas industry.<sup>56</sup>

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47. See *supra* text accompanying notes 8-17.

48. See *supra* notes 16-17 and accompanying text.

49. See *supra* note 18 and accompanying text. For example, in one case a long-term contract called for sale prices of 32¢ per mcf for the first year and 33¢ per mcf the second year. Royalties were based on these amounts. Shortly after the contract was executed, the Federal Power Commission raised the ceiling price for this regulated gas as high as \$1.30 per mcf. See *Tara Petroleum Corp. v. Hughey*, 630 P.2d 1269, 1271 (Okla. 1981).

50. Lowe, *supra* note 8, at 146; see *supra* note 21. Also, most courts make no real distinction between market value and market price. See, e.g., *Arkansas Natural Gas Co. v. Sartor*, 78 F.2d 924 (5th Cir. 1934), *cert. denied*, 296 U.S. 656 (1935).

51. See Harmon, *Gas Royalty—Vela, Middleton, and Weatherford*, 32 INST. ON OIL & GAS L. & TAX'N 65, 69 (1982). See *supra* note 39 for a discussion of deductible expenses.

52. See 1 E. BROWN, *supra* note 7, § 6.09, for an excellent discussion of the cases in the different jurisdictions.

53. See, e.g., *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866, 871 (Tex. 1968) (market value is not the contract price but is the market price at time of delivery instead).

54. *Vela*, 429 S.W.2d at 870. This view also defines "at the well" to be on the actual lease in question. See, e.g., *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 243-44 (Tex. 1981). See *infra* text accompanying note 101.

55. *Tara Petroleum Corp. v. Hughey*, 630 P.2d 1269, 1274 (Okla. 1981).

56. *Id.* at 1273-74.

## B. *Early Case Law*

The first major case dealing with the market value issue was *Foster v. Atlantic Refining Co.*<sup>57</sup> In *Foster*, the lessors brought suit to recover royalties computed under a twenty-year gas sales contract.<sup>58</sup> However, the royalty clause differed from those usually found in leases. It stated that the royalties were to be calculated as one-eighth of the oil and gas, "the same to be delivered to the credit of the Lessor . . . and to be sold at the market price therefor prevailing for the field where produced *when run*."<sup>59</sup> The lessee paid royalties based on the 1950 sales contract, but by 1957, the market price was higher than that provided for in the contract.<sup>60</sup> The lessors claimed entitlement to royalties based on this higher amount.<sup>61</sup>

In holding for the lessors, and affirming this portion of the trial court's decision, the Court of Appeals for the Fifth Circuit determined that the "market price" referred to in the lease was not the gas sales contract price.<sup>62</sup> The court refused to consider the defense that this higher royalty would be burdensome to the lessee, stating that the lessee entered into the sales contract with full knowledge and took the risk of that contract producing royalties satisfactory to the lease terms.<sup>63</sup> Considering the peculiar royalty clause language in the lease, it is not difficult to see why the court reached this result.<sup>64</sup> The words "when run" imply that a specific time was intended.<sup>65</sup> As a result of this limiting language,

57. 329 F.2d 485 (5th Cir. 1964).

58. *Id.* at 487-88. In 1950, the lessees entered into a gas sales contract which provided for price escalation for three successive five-year periods. For the fourth five-year period, the price was to be "the fair and reasonable value" of gas of similar quality and quantity, provided that it would not be less than 10.0883 cents per mcf. *Id.* at 488.

59. *Id.* (emphasis added).

60. *Id.* In 1957 the price prevailing in the field was 13 cents and from 1958-1962 was 14 cents. *Id.*

61. *Id.*

62. *Id.* at 489-90.

63. *Id.* at 489. The court stated:

The inability of Atlantic to make a gas sales contract with escalation provisions is beside the point. The obligation of Atlantic to pay royalties is fixed and unambiguous. It made the gas sales contract with full knowledge of this obligation and did nothing to protect itself against increases in price. The fact that its purchaser would not agree to pay the market price prevailing at the time of delivery does not destroy the lease obligation.

*Id.*

64. See Morris, *The Gas Royalty Clause—What is Market Value?*, 25 INST. ON OIL & GAS L. & TAX'N 63, 68 (1974).

65. *Id.* Furthermore, it seems that "when run" was inappropriate language to use in referring to natural gas. According to Morris, since the royalty clause did not suggest that the phrase was to refer to other substances, the use of the current price was the correct interpretation. *Id.* at 68-69.



the *Foster* decision had only a slight impact on the oil and gas industry.<sup>66</sup>

The next major case was *J.M. Huber Corp. v. Denman*,<sup>67</sup> which also involved a peculiar fact situation. The lessor in *Denman* required the lessee to obtain a gas purchase contract prior to the making of the lease.<sup>68</sup> The purchase contract called for a price of 3.5¢ per mcf for ten years, and 4¢ per mcf thereafter.<sup>69</sup> However, the lease called for a royalty calculation of 4¢ per mcf for the first ten years, and market price thereafter.<sup>70</sup>

In holding that the market price was not the contract price, the court noted that, although the contract and the lease stated different prices,<sup>71</sup> the lessee had paid royalties based upon the 4¢ per mcf price of the lease rather than upon the contract price.<sup>72</sup> The court observed that "the construction put on the contract by responsible action of the parties is frequently the best revelation of its purpose . . . ."<sup>73</sup> Finally, the court stated that it would not focus on the particular transaction but instead would look at a "theoretical one" between a free seller and a free buyer dealing at arm's length.<sup>74</sup>

### C. Texas Oil & Gas Corp. v. Vela

Two years after *Denman* was decided, the Texas Supreme Court decided what has become the leading case in this controversy. *Texas Oil & Gas Corp. v. Vela*<sup>75</sup> involved a lease which was executed in 1933.<sup>76</sup> It

66. Lowe, *supra* note 8, at 147-48.

67. 367 F.2d 104 (5th Cir. 1966).

68. 367 F.2d at 108. Accordingly, the lessee entered into a contract with an interstate pipeline company before the lessor executed the lease. *Id.*

69. *Id.* at 108-09. The contract was renegotiated in 1961 at 11 cents per mcf. *Id.*

70. *Id.* at 107. The lease provided that the payments would never be calculated at less than 4 cents per mcf. *Id.*

71. *Id.* at 108-09.

72. *Id.* at 109. Thus, an inference arose that the contract price was not intended by the parties to be the market value. *Id.*

73. *Id.* at 109.

74. *Id.* The industry anticipated, nevertheless, that the Federal Power Commission (F.P.C.), which controlled the regulated interstate ceilings, would limit problems through the use of a ceiling price. The ceiling rate would then be both amount realized and market price. On remand, the F.P.C. asserted jurisdiction over royalty owners. The Court of Appeals for the District of Columbia refused to recognize the jurisdiction of the F.P.C. because royalty owners do not "sell" gas in interstate commerce. *Mobil Oil Corp. v. Federal Power Comm'n*, 463 F.2d 256, 263 (D.C. Cir. 1972), *cert. denied*, 406 U.S. 976 (1972), *reh'g denied*, 409 U.S. 902 (1973). The intricacies of interstate gas regulation are beyond the scope of this paper. The reader's attention is directed to 1 E. BROWN, *supra* note 7, at § 6.09(2), for a more extensive discussion of the controversy as applied to federal regulations.

75. 429 S.W.2d 866 (Tex. 1968).

76. *Id.* at 868.

provided that the royalty was to be calculated for gas sold or used off the premises as "one-eighth of the market price at the wells of the amount so sold or used."<sup>77</sup> The long-term gas sales contracts entered into in 1935 and 1937 provided a price of 2.3¢ per mcf.<sup>78</sup> The lessors brought suit to recover<sup>79</sup> alleged deficiencies in payments for the years 1960 through 1964.<sup>80</sup> During those years, other gas sales contracts from the same field provided much higher prices.<sup>81</sup>

The Texas Supreme Court found for the lessors and stated that the royalties are to be determined from the provisions of the lease and not from the contract.<sup>82</sup> The court, following *Foster*, decided that the sales contract price was not the lease's market price.<sup>83</sup> The court based this decision upon the fact that part of the royalty clause stated that royalties for certain gas sold at the well were to be based on the proceeds of its sale.<sup>84</sup> The court stated:

It is clear then that the parties knew how to and did provide for royalties payable in kind, based upon market price or market value, and based upon the proceeds derived by the lessee from the sale of gas. They might have agreed that the royalty on gas produced from a gas well would be a fractional part of the amount realized by the lessee from its sale. Instead of doing so, however, they stipulated in plain terms that the lessee would pay one-eighth of the market price at the well of all gas sold or used off the premises.<sup>85</sup>

Accordingly, the court rejected the lessees' argument that the gas was "sold" at the time the long-term gas sales contracts were executed. The court found, instead, that the gas was "sold" when delivered to the purchaser.<sup>86</sup>

The court also rejected the argument, similar to that made by the lessee in *Foster*, that this interpretation of "market value" is burdensome

77. *Id.*

78. *Id.* at 870. These contracts were for the "life of the lease." *Id.* at 868.

79. The lessors sued for additional relief on the theory that the premises were being drained and not developed properly. *Id.* at 870. That issue was severed and remanded to the district court for a determination of damages after the Texas Court of Civil Appeals found for the lessors. *Id.* at 869.

80. *Id.* at 868.

81. *Id.* The trial court found that during this four-year period the market price was 13.047 cents per mcf. *Id.* at 869.

82. *Id.* at 870. The court stated that the lease "was executed prior to and is wholly independent of the gas sales contracts." *Id.*

83. *Id.* at 871.

84. *Id.*

85. *Id.*

86. *Id.* The court cited as support *Martin v. Amis*, 288 S.W. 431, 433 (Tex. Comm'n App. 1926, judgment adopted).

to the lessee.<sup>87</sup> The court stated that "the market price of gas is to be determined by sales of gas comparable in time, quality and availability to marketing outlets."<sup>88</sup>

The dissent disagreed with the majority's holding that market price is determined at the time of delivery.<sup>89</sup> The dissent distinguished *Foster* because of its peculiar royalty clause language.<sup>90</sup> The dissent stated that courts should look to the customs of the industry in order to determine at what time the market price is to be determined.<sup>91</sup>

Several commentators generally agree with the dissent in *Vela*.<sup>92</sup> One commentator argues that *Foster* should not be controlling in the absence of language in the clause to the effect that market price is to be determined in the future.<sup>93</sup> These critics also state that *Vela* should not be followed by jurisdictions which have not yet decided the issue.<sup>94</sup> They urge that the facts and circumstances known to both lessor and lessee should be examined instead.<sup>95</sup>

Despite these criticisms, in 1981 the Texas Supreme Court affirmed

87. 429 S.W.2d at 871; see *supra* note 63 and accompanying text.

88. 429 S.W.2d at 872. The court agreed with the court of civil appeals that "the mathematical average of all prices paid in the field is not a final answer to the difficult problem of determining market price at any particular time." *Id.* at 873. The court also found that objections to the basis of an expert's testimony go only to weight and not to admissibility. *Id.* at 872.

89. *Id.* at 878. Four justices dissented.

90. *Id.* at 880 (Hamilton, J., dissenting). Justice Hamilton stated that "[t]he problem before us is by no means the problem that the 5th Circuit had in the *Foster* case." *Id.*

91. *Id.* at 879. Justice Hamilton wrote:

[W]e must look to common practices in the industry at the time the lease contract was made in 1933 to ascertain what was the *intention of the parties with reference to this matter* [determining when "market price" is to be computed]. All parties agree and this Court so holds that at such time the only sales for gas from wells producing gas only were made on long-term contracts or for the life of the lease. The parties, when they entered into the lease contract, knew how such gas had to be marketed; it had to be marketed under a contract similar to the one before us. Consequently, when the parties entered into the lease contract they all knew that the term "market price" necessarily meant the price prevailing for gas on long-term contract *as of the time the sale contract should be made*.

*Id.* (emphasis added).

92. *Accord* 3A W. Summers, *Oil & Gas Leases* § 589 (Supp. 1984); see Fischl, *supra* note 8, at 31; Hoffman, *Oil and Gas Royalty Problems—Current Issues and Answers*, 31 INST. ON OIL & GAS L. & TAX'N 211, 211 (1980); Morris, *supra* note 64, at 75.

93. Morris, *supra* note 64, at 75.

94. 3A W. SUMMERS, *supra* note 92, § 589, at 13; Morris, *supra* note 64, at 75.

95. Morris, *supra* note 64, at 83. The result in *Vela* surprised the industry. See, e.g., Hollimon, *supra* note 8, at 9 n.24. The industry representatives considered the terms of the royalty clause in *Foster* to be so unusual that they believed the phrase "when run" played a central role in the *Foster* court's decision and considered the *Foster* decision as being effectively limited to its facts. Consequently, *Vela* surprised many persons in the industry despite the clear implication of the language in *Foster*. *Id.* See also Lowe, *supra* note 8, at 149-50. The lease draftsmen abandoned the use of royalty clauses containing references to "market value" or "market price". Others tried to protect themselves by drafting division orders from the lessor to the lessee with language purporting to amend the underlying leases to change market value royalty provisions to proceeds provisions. *Id.*

and expanded the *Vela* rule in *Exxon Corp. v. Middleton*.<sup>96</sup> Exxon secured leases with royalty clauses providing that royalties for gas “produced from said land and sold or used off the premises” were to be calculated by “the market value at the well of one-eighth of the gas so sold or used . . . .”<sup>97</sup> For gas “sold at the wells,” royalties would be “one-eighth of the amount realized from [the] sale.”<sup>98</sup> The lessors sought to recover alleged deficiencies in royalties for the years 1973 through 1975.<sup>99</sup> The court in *Middleton* followed *Vela* in holding that market value and amount realized do not have the same meaning.<sup>100</sup> However, the court expanded upon *Vela*’s holding by construing “sold at the wells” to mean sold at the wells within the lease, and not sold at the wells within the fields.<sup>101</sup> Therefore, a market value rate was applied to all gas sold off the lease.<sup>102</sup> The court also determined that gas is “sold” when it is delivered, since “produced” refers to its being extracted.<sup>103</sup> The court also further developed the *Vela* holding as to how market value is to be calculated.<sup>104</sup>

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96. 613 S.W.2d 240 (Tex. 1981).

97. *Id.* at 241. Sun Oil Company was also a defendant. Its royalty clause was substantially the same. *Id.* at 242.

98. *Id.*

99. *Id.* at 241.

100. *Id.* at 245. The court found that the parties did not use “market value” and “amount realized” interchangeably and rejected Exxon’s assertion that essentially the same meaning was intended for both. *Id.*

101. *Id.* at 243-44. In doing so, the court disapproved a lower court’s holding in *Butler v. Exxon Corp.*, 559 S.W.2d 410 (Tex. Civ. App. 1977), that the Texas Supreme Court had refused to examine. In *Butler*, the trial court found that “sold at the wells” included sales, i.e., deliveries, anywhere in the vicinity of the field. *Id.* at 414. Thus, the *Butler* sales, occurring off the premises, were determined to be “at the wells” as understood in the industry, and royalty was then based upon amount realized. The *Middleton* decision limited “sold at the wells” to the lease and not the field.

102. 613 S.W.2d at 243. The court concluded that “off the premises” modified both “used” and “sold” as opposed to Exxon’s argument that “off the premises” modified only the word “used” and thus royalty for all gas sold should be calculated by the amount realized clause as a proviso to the market value section. *Id.* See Harmon, *supra* note 51, at 82-83, and Lowe, *supra* note 8, at 154, for discussions of this interpretation.

103. 613 S.W.2d at 244. The court rejected Exxon’s arguments that the “practicalities of the natural gas industry require [the courts] to construe ‘sold’ to mean the time the gas becomes committed to a bona fide long-term gas contract . . . .” and stated that “[a]lthough as between Exxon and its customers, the gas may have been sold when the contracts became effective, there is no basis in the royalty clause for applying such a definition to the lease agreements.” *Id.* at 245 (footnotes omitted). The court cited *Foster* in deeming it unfortunate that subsequent increases in market value would impose a financial burden upon the lessee. *Id.*

104. *Id.* at 245-49. Factors the court mentioned in defining comparable sales were time, quality, quantity, and availability of marketing outlets. *Id.* at 246 (citing *Vela*, 429 S.W.2d at 872; see *supra* note 88 and accompanying text. Furthermore, the court in *Middleton* found that

[s]ales comparable in time occur under contracts executed contemporaneously with the sale of the gas in question. Sales comparable in quality are those of similar physical properties such as sweet, sour, or casinghead gas. Quality also involves the legal characteristics of the gas; that is, whether it is sold in a regulated or unregulated market, or in one

Comparable to the *Vela* decision, the *Middleton* case has been criticized as causing inconsistencies or ridiculous results in the industry.<sup>105</sup> Contrary to the court's holding, use of the term "at the well" in royalty clauses was intended by those in the industry to allow the deduction of processing costs and other costs subsequent to production.<sup>106</sup>

It appears that the *Vela* theory has been followed in at least two other jurisdictions. The Kansas Supreme Court, in *Lightcap v. Mobil Oil Corp.*,<sup>107</sup> followed the *Vela* approach in a context different from that in *Vela* and *Middleton*. In *Lightcap*, the gas contracts covered the regulated interstate market and, therefore, were bound by Federal Power Commission (FPC) regulations.<sup>108</sup> In construing the lease against the lessee and in favor of the lessor,<sup>109</sup> the court found that the clause calling for royalties based on market value meant current market value or price and did

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particular category of a regulated market. Sales comparable in quantity are those of similar volumes to the gas in question. To be comparable, the sales must be made from an area with marketing outlets similar to the gas in question.

613 S.W.2d at 246-47 (footnotes omitted); see also *Weymouth v. Colorado Interstate Gas Co.*, 367 F.2d 84, 90 (5th Cir. 1966) (standard test for determining the market value of gas sold on interstate market is what a willing seller and a willing buyer agree to take and pay, subject to industry regulations and FPC [now FERC] approval); *Phillips Petroleum Co. v. Bynum*, 155 F.2d 196 (5th Cir. 1946) (market value of gas is to be determined by sales of gas comparable in time, quality and availability of marketing outlets), *cert. denied*, 329 U.S. 714 (1946). For additional discussions of these determinations, see Hollimon, *supra* note 8, at 71-76; Note, *The Market Value Controversy: Exxon Corp. v. Middleton*, 16 TULSA L.J. 550 (1981).

105. Professor Lowe aptly described this inconsistency:

[T]he court's decision to make the royalty measurement dependent upon the delivery point of the gas may well lead to ludicrous results. Suppose, for example, that A Company leases from O under four separate but identical leases containing the *Middleton* royalty formulation or similar language, in the northeast, northwest, southeast and southwest quarter sections of a township. Suppose further that wells are drilled on each of the four quarter sections and that the gas from the wells is committed to sale under a single gas contract. Suppose finally that the gas pipeline at which deliveries are made runs East-West across the northeast and northwest quarter sections so that the meters for the wells on the leases of the northwest and southwest quarter sections are set on the northwest quarter section while the meters for the wells on the northeast and southeast quarter sections are set on the northeast quarter section. If the gas contract provides, as is typical, that the ownership of the gas passes at the meter, then under the *Middleton* decision, royalties on gas from the wells on the northeast and northwest quarter sections would be calculated on the basis of the amount realized by the lessee under the terms of the gas contract because sales would take place on the leased premises. But royalties on gas from the wells drilled on the southeast and southwest quarter sections would be calculated on the basis of current market value when delivered because the sales would take place "off the premises."

Lowe, *supra* note 8, at 155-56.

106. See *supra* notes 39, 51 and accompanying text. Lowe, *supra* note 8, at 156, states that apparently these decisions are "nothing but an application of the time honored rule of construction that a contract is to be construed against the drafting party, since he is in the best position when the contract is drafted to avoid any problems." *Id.* But see 2 W. SUMMERS, OIL & GAS LEASES § 372 (2d ed. 1958) (criticizing this rule of construction).

107. 221 Kan. 488, 562 P.2d 1, *cert. denied*, 434 U.S. 876 (1977).

108. *Id.* at —, 562 P.2d at 4.

109. *Id.* at —, 562 P.2d at 9.

not mean the amount realized.<sup>110</sup> The court stated that the federal regulations over the rates the lessee can receive as sales contract prices do not prevent a higher rate from being fixed as market value in a lease royalty clause.<sup>111</sup> Thus the "market value" was neither the contract price nor the FPC-approved price.

The *Lightcap* decision was followed by the Montana Supreme Court in *Montana Power Co. v. Kravik*.<sup>112</sup> The trial court used FPC regulations to determine market value for gas that was sold in the intrastate market.<sup>113</sup> The supreme court found, instead, that market value is the current market price being paid for gas at the well where it is produced, regardless of FPC regulations.<sup>114</sup>

#### D. Tara Petroleum Corp. v. Hughey

The Oklahoma Supreme Court adopted a position similar to the dissent in *Vela*. In *Tara Petroleum Corp. v. Hughey*,<sup>115</sup> the court construed the lease royalty clause containing the phrase "market price at the well" for gas sold or used off the premises to refer to the gas sales contract price.<sup>116</sup> The court felt that it would be unfair to producers to require them to pay as royalty up to one-half of what they received.<sup>117</sup> The court felt that this was unfair because the lessee is forced into a contract by his duty to the lessor.<sup>118</sup>

The court limited its ruling, however, by requiring that the gas sales

110. *Id.* at —, 562 P.2d at 10.

111. *Id.* at —, 562 P.2d at 8. The court stated that payment should be based on a theoretical free market. *Id.* at —, 562 P.2d at 11. Apparently, though, the court did not set more guidelines than this. *Id.* at —, 562 P.2d at 30-31 (Fromme, J., dissenting).

112. 586 P.2d 298 (Mont. 1978).

113. *Id.* at 300.

114. *Id.* at 302. Thus, the court held the regulations irrelevant. *Id.*

115. 630 P.2d 1269 (Okla. 1981). The lease was executed in 1973 by Tara Petroleum. Through a series of assignments, the lease was assigned eventually to Wilcoy Petroleum. In 1976, Wilcoy entered into a gas purchase contract. The contract was for two years and was terminated at the end of the period. The royalties were based on the contract price. *Id.* at 1271.

116. *Id.* at 1272.

117. *Id.* As an example, the court considered the situation in *Tara* itself:

Under their contract the producers received 32¢ per mcf the first year. The royalty share of that amount, one eighth, is 4¢. Yet by the end of the first year the first purchaser, Jarrett, was receiving nearly \$1.28 for the gas. One eighth of \$1.28 is 16¢. So if royalty were measured by the price El Paso Natural Gas paid Jarrett, the lessors' royalty would have quadrupled in one year—to one half of the producers' revenues.

*Id.* at 1273.

118. *Id.* at 1273; see *supra* note 14 and accompanying text. The court also discussed the contemplation of the parties when they negotiate the oil and gas leases, and the knowledge the parties have of the industry. 630 P.2d at 1273.

contract be entered into at arm's length and in good faith.<sup>119</sup> If so, the lease's market price will be the contract price.<sup>120</sup> The burden is on the lessor-plaintiff, however, to prove that the contract was unfair or illusory.<sup>121</sup> Since there was no indication of this in *Tara*, the court found for the lessees.<sup>122</sup> To date, the *Tara* view has been followed in Arkansas<sup>123</sup> and Louisiana,<sup>124</sup> and is held as the better view by several commentators.<sup>125</sup> One commentator stated:

The decision in *Tara* is ultimately more fair than that of other jurisdictions. It is more closely in line with the contemplated results of both parties when they entered the lease. As the court remarked, surely the lessor never expected that his royalty could be half of what the producer received for the gas. That this rule is advantageous and fair to the lessee is obvious. But at the same time it does not create an undue hardship on the lessor, because he receives the benefit of the agreement which he made with the lessee.<sup>126</sup>

#### IV. THE DECISION IN *PINEY WOODS COUNTRY LIFE SCHOOL V. SHELL OIL CO.*

In response to the lessors' argument that they deserved higher royalty payments, the court in *Piney Woods* examined several specific phrases in the oil and gas leases. One such phrase was "sold at the wells."<sup>127</sup> The court determined that this phrase implies a distinction between gas in its natural state and gas to which value has been added by transportation or by processing, and is not just a term referring to when

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119. *Id.* The court stated that

if the contract was not reasonable when entered into, if it is not at a minimum fair and representative of other contracts negotiated at the time in the field, then a different result [than contract price equaling "market value"] obtains. Then the lessee has not protected his lessor in discharging his duty to market the gas, and there is no policy in the law requiring the courts to protect the lessee in interpreting the lease.

*Id.* at 1274.

120. *Id.* at 1273.

121. *Id.* at 1274.

122. *Id.* at 1276. There was some argument that *Tara* and the purchaser were commonly controlled, but the court held that not enough proof was shown and the plaintiffs did not meet their burden of proof. *Id.* at 1275.

123. Hillard v. Stephens, 276 Ark. 545, 637 S.W.2d 581 (1982); see also Note, Hillard v. Stephens: Interpretation of Price Royalty Provisions in Natural Gas Leases, 36 ARK. L. REV. 312 (1982).

124. Henry v. Ballard & Cordell Corp., 418 So. 2d 1334 (La. 1982).

125. See 3A W. SUMMERS, *supra* note 92, § 589; Note, Oil and Gas: Market Price Under a Long-Term Gas Contract: Tara Petroleum Corp. v. Hughey, 35 OKLA. L. REV. 427 (1982); Note, Market Value and Long-Term Purchase Contracts: Tara Petroleum Corporation v. Hughey, 17 TULSA L.J. 566 (1982).

126. Note, Market Value and Long-Term Purchase Contracts: Tara Petroleum Corporation v. Hughey, 17 TULSA L.J. 566, 583 (1982) (footnotes omitted).

127. Piney Woods Country Life School v. Shell Oil Co., 726 F.2d 225, 230 (5th Cir. 1984).

the gas is sold.<sup>128</sup>

The court considered whether Shell actually sold the gas “at the well.”<sup>129</sup> Although the sales contracts provided that title passed in the field,<sup>130</sup> the actual sale prices were determined off the field after processing and transportation.<sup>131</sup> The court stated that “the simple passage of title does not control whether the gas was ‘sold at the well’ within the meaning of the leases.”<sup>132</sup> The court reasoned that to decide otherwise would place the lessors at the mercy of the lessee since the lessors had no say as to where title would pass.<sup>133</sup> Therefore, for two of the lease royalty clause provisions, the gas was not “sold at the wells” since processing and transportation added to the value of the gas.<sup>134</sup>

The court also focused on the meaning of the phrase “market value.” Because the gas was not sold “at the wells,” two lease provisions required that the royalties be calculated according to market value.<sup>135</sup> In affirming the district court’s holding that a gas sales contract is executory and executed only upon production and delivery,<sup>136</sup> the court looked to the Uniform Commercial Code as applied in Mississippi.<sup>137</sup> Because the

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128. *Id.* at 231. The “Commercial” and the “Producers 88-D9803” royalty clauses provided that royalty on gas “sold at the wells” was to be based on amount realized from the sale, while the royalty for other gas was to be based on “market value at the well.” The “Producers 88 (9/70)” clause based the royalty for *all* gas sold on amount realized computed at the well. Royalty for gas used by the lessee was based on market value at the well. *Id.* at 229; *see supra* note 31 and accompanying text.

To reach this determination, the court considered the purpose of the gas royalty clause. *Id.* at 230. The court quoted Harmon [*supra* note 51] but rejected his theory that market value would not exceed actual proceeds. 726 F.2d at 231; *see infra* note 143 and accompanying text.

129. 726 F.2d at 231.

130. *Id.* at 229.

131. *Id.* at 231; *see supra* note 37 and accompanying text. For example, the payment for the MisCoa contract was based on the amount of processed gas delivered. 726 F.2d at 231.

132. 726 F.2d at 232. The court rejected the district court’s finding that the gas was sold in the fields due to the provisions of the Uniform Commercial Code. *Id.* at 231-32.

133. *Id.* at 232. Also, “strange results” may occur if “sold at the wells” is based solely on where title passed.

For example, if gas from several leases is delivered at a single point in the fields some lessors may be entitled to market value royalty while others receive proceeds royalty; similarly, gas produced from one lease through a directional well drilled on another lease would be sold “off the lease” even if delivered at the wellhead itself.

*Id.* (citing Hollimon, *supra* note 8, at 47-49, 48 nn.185-86).

134. 726 F.2d at 233.

135. *Id.* at 230; *see supra* note 128. The district court held that Shell owed market value royalty under all the leases for gas used in off-lease operations. 539 F. Supp. 957, 977 (S.D. Miss. 1982); *see supra* note 43 and accompanying text. This holding was not appealed. 726 F.2d at 233. The district court defined “market value” as value when the gas is delivered rather than when the gas sales contract is made. 539 F. Supp. at 981.

136. 539 F. Supp. at 981.

137. 726 F.2d at 234 nn.9-10, (examining MISS. CODE ANN. §§ 75-2-105 (gas is future goods) and 75-2-107(1) (sales contracts are only effective when gas is severed from land) (1981)).



leases could terminate under certain conditions, Shell had only a defeasible interest in the gas. If the leases terminated, then title would revert to the lessors<sup>138</sup> and the purchasers would have no claim to the gas itself.<sup>139</sup> Thus the gas was not sold until produced and delivered. The purchasers did not have control of the gas until that time.<sup>140</sup>

In determining the meaning of "market value," the court examined both the *Vela* and the *Tara* views.<sup>141</sup> The court adopted the *Vela* view in respect to when gas is sold,<sup>142</sup> and expressly refuted the theory of commentators that market value cannot exceed actual proceeds or amount realized.<sup>143</sup> This theory is that "market value" is simply actual proceeds or actual proceeds less processing expenses.<sup>144</sup> The court criticized this interpretation because gas that is consumed off the premises has no actual proceeds. The court reasoned that the royalties for both gas consumed and the gas sold should be computed using the same formula.<sup>145</sup> Furthermore, the court stated that Shell should have known of the meaning given to "market value" by earlier cases such as *Foster* and *Vela*.<sup>146</sup> The court reasoned that Shell could have used "proceeds" clauses if such were desired.<sup>147</sup>

Shell claimed that basing royalty payments upon good faith contract prices was an accepted custom within the oil and gas industry. The court rejected this claim by pointing out, "[f]or a practice to be legally relevant custom, both parties to the contract must have actual or presumed knowledge of the practice."<sup>148</sup> As the lessors "cannot be presumed to know"<sup>149</sup> of such a practice, custom would not be binding.<sup>150</sup> The court rejected the argument that it would be unfair to determine that market value is the current market value. *Tara's* view, allowing such an inter-

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138. 726 F.2d at 234. For example, Shell may breach implied or express covenants or there may be a cessation of production. *Id.*

139. *Id.*

140. *Id.* at 235. The court backed its conclusion on the explicit distinctions in the lease between gas sold at the well and that sold off the lease, and between amount realized and market value. *Id.*

141. *Id.* at 233.

142. *Id.* at 233-35; see *supra* notes 136-40 and accompanying text.

143. 726 F.2d 235 (disagreeing with Harmon, *supra* note 51, at 69, and Lowe, *supra* note 8, at 146).

144. See *supra* notes 50-51 and accompanying text.

145. 726 F.2d at 235.

146. See *supra* notes 62, 83 and accompanying text.

147. 726 F.2d at 236.

148. *Id.*

149. *Id.*

150. *Id.* In *Shell Oil Co. v. Williams, Inc.*, 428 So. 2d 798 (La. 1983), Shell stipulated that the market value was the current market value. The appellate court used this case to show that the current market value view was not unheard of. See 726 F.2d at 236.

pretation when the contract was entered into at arm's length and in good faith, was rejected as well. The court stated that while "[w]e appreciate that a lessee may find itself economically disadvantaged when its royalty obligations increase while its sale revenues remain constant, . . . this [disadvantage] is no more than the risk assumed by every business venturer who undertakes the role of middleman."<sup>151</sup> Furthermore, "[i]t is not the function of the courts, construing and enforcing contracts under state law, to intervene on behalf of producers experienced in the petroleum industry, and thereby deprive lessors of their legitimate contractual expectations."<sup>152</sup>

The court concluded that *Tara's* view was unfair to the lessors who might interpret market value language as meaning current market value. These lessors might decide to take the risk that the current market value would rise and therefore pick a lower "market value" percentage royalty clause over a higher "amount realized" one.<sup>153</sup>

The court refused to reconsider the district court's method of proving market value, holding that the district court was within its discretion to seek evidence of comparable sales.<sup>154</sup> Finally, the court allowed Shell to deduct processing and transportation costs for gas sold in order to compute market value "at the well."<sup>155</sup> Because production ends when the gas is extracted, expenses subsequent to production may be charged to royalty when royalty is computed "at the well."<sup>156</sup> The case was remanded to determine market value and the existence of reasonable expenses subsequent to production.<sup>157</sup>

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151. 726 F.2d at 237.

152. *Id.*

153. *Id.* The court stated that it would be unfair to the lessors if "market value" equalled "amount realized." "By enforcing the clear terms of the market value lease, we preserve those expectations and provide opportunities and incentives for the parties to make new contracts more nearly reflecting current economic conditions." *Id.* at 238.

154. *Id.* at 238. "Market value is a question of fact, and it is up to the factfinder to determine the probative strength of relevant evidence." *Id.* "The only general rule that emerges from [the various] cases is that the method of proof varies with the facts of each particular case." *Id.* For one example, see *Montana Power Co. v. Kravik*, 187 Mont. 87, 586 P.2d 298 (1978) (two methods are lease comparison and receipts less costs and expenses).

155. 726 F.2d at 240. Also, under the "88 (9/70)" clause, amount realized for all gas sold was to be computed at the "mouth of the well." *Id.* at 240-41; see *supra* note 128. The court rejected authority that production includes marketing efforts. See *supra* note 39.

156. 726 F.2d at 240 (citing 3 H. WILLIAMS, OIL AND GAS LAW § 645 (1981)). These processing costs must be reasonable. *Id.* at 241.

157. *Id.* at 238-39, 241. The court also held that royalty must be paid for plant fuel, i.e., gas Shell uses from lessors' leases for operations at Shell's plant. The lower court had allowed the claim for royalty for gas used by Shell on other leases but had denied the lessors' claim for royalty on plant fuel. *Id.* at 241; see *supra* note 43. The appellate court held that if the costs are reasonable, royalties paid on plant fuel can be charged back to lessors as a processing cost. 726 F.2d at 241. Shell had

## V. ANALYSIS

The *Piney Woods* opinion appears to incorporate both approaches of the market value royalty clause controversy. These approaches consider the "intention of the parties" and the "plain meaning of the words." The "intention of the parties" approach establishes that "at the well" refers to the physical properties of the gas produced. This approach opposes the *Middleton* view that "at the well" refers to gas actually sold on the leased property.<sup>158</sup> The intention of the parties approach is a better interpretation of the phrase "at the well" for several reasons. First, the use of the term "market value at the well" in a gas royalty clause was an attempt by draftsmen to calculate royalties on gas sold or used off the premises.<sup>159</sup> The royalties were based on the sales contract price less the lessor's share of the transportation, processing and other costs.<sup>160</sup> Therefore, the *Piney Woods* meaning of "at the well" considers the actual intention of the industry.<sup>161</sup>

Second, this interpretation avoids *Middleton's* view that "at the well" and "off the premises" are mutually exclusive.<sup>162</sup> *Middleton* defined "sold at the well" as sold within the lease.<sup>163</sup> This interpretation causes absurd results because practically identical leases are treated differently.<sup>164</sup> Furthermore, it appears that "the commonly accepted definition in the oil and gas industry [is] that 'at the well' means in the area or in the field."<sup>165</sup> While the court in *Piney Woods* did not adopt this liberal interpretation of "at the well,"<sup>166</sup> its interpretation will avoid the incon-

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claimed that this would result in a "wash," but the district court held that the lessors are still entitled to this royalty determination. *Id.* The court affirmed the district court's denial of the lessors' claim for prejudgment interest and attorney fees. *Id.* at 241-42.

158. 613 S.W.2d 240, 243 (Tex. 1981).

159. See *supra* note 51 and accompanying text; Lowe, *Developments in Nonregulatory Oil and Gas Law: Issues of the Eighties*, 35 INST. ON OIL & GAS L. & TAX'N 1, 3 (1984).

160. See Lowe, *supra* note 159, at 3. The lessee was "working back" from the actual amount realized from the sale to a value before the increase. *Id.*

161. The court followed this approach when it deducted these costs in computing "market value" once it had defined "market value." 726 F.2d at 240; see *supra* text accompanying note 156.

162. 613 S.W.2d at 243; see *supra* note 102 and accompanying text; Lowe, *supra* note 159, at 8.

163. 613 S.W.2d at 243.

164. See *supra* note 105. *Middleton* itself caused an absurd result in that the lessor on whose property the plant was located was the only one who obtained royalties based on amount realized, while the other lessors near him received market value royalties. See Lowe, *supra* note 8, at 156.

165. Lowe, *supra* note 159, at 9.

166. 726 F.2d at 227. The district court did interpret "at the well" this liberally by holding that the sales contract, which provided points in the field as points of sale, (i.e., title passed in the field), embodied the intention of the parties. 539 F. Supp. 976-77. The district court found that "the use of 'off the premises' and 'at the well' . . . does not describe circumstances intended to be mutually exclusive." *Id.* at 977.

sistent results caused by *Middleton*.<sup>167</sup> Hopefully, this decision will dampen litigation concerning determination of actual sales point.

Nevertheless, this liberal interpretation was not extended throughout the opinion. In its express rejection of several commentators' views, the court held that market value does not refer to contract price or something less than contract price.<sup>168</sup> This court used the "plain meaning of the words," or *Vela* approach, to define market value as current market value.<sup>169</sup> The court stated several reasons for its conclusions. One reason is that gas sales contracts are only executory;<sup>170</sup> therefore, gas is not sold until it has been produced and delivered.<sup>171</sup> According to the court, another reason is that gas used off the premises does not have the actual proceeds upon which a royalty can be based. Therefore, the market value approach must be used. The final reason is that custom cannot be binding on parties unless they have actual or presumed knowledge of it.<sup>172</sup> The custom in the industry of using actual proceeds as the basis for royalty was rejected.

There are problems with each step of the court's analysis. In holding that the gas sales contract is executory and that gas is not sold until it has been produced and delivered to the purchaser, the court overlooked the reality of the industry. While the court's interpretation of the Uniform Commercial Code in Mississippi is correct,<sup>173</sup> the court failed to realize that, for all practical purposes, the gas is "sold" for the parties to the lease when the sales contract is made.<sup>174</sup> The Uniform Commercial Code should not have been so strictly applied to the situation between the lessee and the lessor, although it does apply to the contract.

Another problem with the court's analysis concerns the discussion of gas used off the premises. The court decided that market value could not be the same as or less than actual proceeds for gas used off the premises because there are no proceeds for gas "used," as opposed to gas

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167. Lowe, *supra* note 159, at 10 n.50a.

168. *Piney Woods*, 726 F.2d at 231; *see supra* notes 50-51 and accompanying text for the rejected view.

169. 726 F.2d at 231.

170. *Id.* at 234.

171. *Id.*

172. *Id.* at 236.

173. The court used MISS. CODE ANN. § 75-2-105 (1981), which states that gas is a future good since it is not "both existing and identified." Furthermore, contracts for the sale of gas are contracts for the sale of goods, but until the gas is severed from the land the contract is "effective only as a contract to sell." *Id.* § 75-2-107.

174. *See supra* text accompanying notes 50-51.

"sold."<sup>175</sup> Admittedly, it is true that no *actual* proceeds exist for this gas. However, when draftsmen base royalty on "market value at the well" for gas "sold or used off the premises," they mean to base royalty on that amount which the gas *could* have been sold for "at the well"—in the field and less certain expenses—as of the date of the contract or contracts selling other gas. Therefore, the same formula was intended for gas used off the premises. The court's reasoning appears to be a weak attempt to back up an interpretation contrary to that intended by the industry. If the industry contemplated and the parties knew that "market value" equals or is less than amount realized, then that formula should be applied to both gas sold and gas used, as the royalty clause states, and should be applied regardless of the fact that no "actual" proceeds exist for some of the gas.

In *Piney Woods*, the court rejected the custom of the industry as a factor in determining market value.<sup>176</sup> The court stated that the parties cannot be presumed to know of such a custom.<sup>177</sup> It did not, however, specifically determine whether these particular parties may have been aware of such a custom.<sup>178</sup>

The problems with following *Vela's* market value approach flow basically from these courts' refusing to recognize the true intention of the parties to the leases in question. Most of these courts have refused to look at the actual parties or transactions but instead have looked to "theoretical" or "presumed" ones.<sup>179</sup> One commentator states that

[i]t is probably not correct to say in construing the royalty clause that the lessor and lessee *in fact intended* "market price" to mean what it was construed to mean in *Vela*; neither would it be correct to say that they *in fact intended* "market price" to mean that price which the lessee was able to obtain in a long-term gas sales contract . . . . It is . . . more nearly correct to say that by construing "market price" to mean that price which the lessee is able to obtain by using his best business judgment is a construction which is likely to be in accord with the *probable intention of the average lessor and lessee*.<sup>180</sup>

The *Piney Woods* court stated that its holding best suits the lessors'

175. 726 F.2d at 235; see *supra* note 145 and accompanying text. Thus market value was not amount realized for gas sold since a uniform application was "more natural." 726 F.2d at 235.

176. 726 F.2d at 236; see *supra* notes 148-49 and accompanying text.

177. 726 F.2d at 236.

178. *Id.*

179. See, e.g., *Lightcap v. Mobil Oil Corp.*, 221 Kan. 488, 562 P.2d 1 ("theoretical free market"), *cert. denied*, 434 U.S. 876 (1977).

180. *Morris*, *supra* note 64, at 78 (emphasis in original).

legitimate contractual expectations;<sup>181</sup> however, deciding that market value is the gas sales contract price or the price less certain expenses would not be foreclosing the lessors' legitimate expectations. If the lessors have not specifically interpreted market value as current market value, then these expectations are merely for royalties, and they would still be receiving such. Furthermore, this argument indicates that it would be wise to inquire into the particular facts and circumstances to determine what the parties actually believed.

Defining "market value" along *Vela's* lines necessitates preventive measures by the industry. Some measures most frequently mentioned are obtaining division orders, passing the costs on to the gas purchasers, and drafting more exact language in the royalty clause.<sup>182</sup> Division orders are authorizations to the purchaser telling him how much he is to pay and to whom he must pay it.<sup>183</sup> However, producers have used the orders in recent years to modify the leases' royalty provisions by specifying that the royalty is to be based on actual proceeds.<sup>184</sup> The lessors appear bound by these orders since they have signed them with the other parties.<sup>185</sup> However, one court found that, because there was no consideration to support the signing, the lessor was not bound.<sup>186</sup> Another court held that even if the lessor was bound, he was released from the order upon filing suit for any additional royalty.<sup>187</sup> The gas division orders could also be viewed as overreaching on the part of the lessee.<sup>188</sup>

Passing the higher royalty payments on to the purchaser also appears ineffective. It may be difficult to persuade the purchaser to sign a contract that contains a provision that he must make up the difference if the lessee is forced to pay higher royalties.<sup>189</sup> Even if the purchaser does sign, then the cost will almost certainly be passed on to the consumer.

It appears that the best alternative would be specific drafting.<sup>190</sup> This alternative does not solve the problem, however. Many leases with the market value language are still in effect. In addition, forms with market value language may still be purchased.

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181. 726 F.2d at 237.

182. See Lowe, *supra* note 8, at 156-67.

183. 4 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 701, at 572 (1984).

184. *Id.* § 705, at 604.

185. Lowe, *supra* note 8, at 157.

186. See *Holmes v. Kewanee Oil Co.*, 664 P.2d 1335 (Kan. 1983).

187. See *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 250 (Tex. 1981).

188. Lowe, *supra* note 8, at 19.

189. Lowe, *supra* note 8, at 163.

190. *Id.* at 166.

## VI. CONCLUSION

These clauses were intended to have a meaning other than that attributed to them by the courts. Rather than being equitable, the courts' interpretations cause more problems for the industry. Therefore, the industry must take some preventive measures. Unfortunately, many of these preventive measures are ineffective. The court in *Piney Woods* made one step in the right direction when it defined "at the well" according to the industry's intended usage. Its failure to make a uniform interpretation is puzzling. It will no doubt cause confusion in Mississippi, as well as in those jurisdictions that have yet to decide the issue. When these jurisdictions address the issue, then perhaps they will realize that the best approach is to interpret according to the particular parties' actual intent. Until this approach gains universal recognition, however, this controversy will continue to breed more litigation and cause more problems for the industry.

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